Capital Account Liberalization in China

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Introduction

- China has a goal of achieving capital-account convertibility (and a market-determined exchange rate) for the Renminbi by 2020.
- Capital-account convertibility means the absence of controls on capital account inflows and outflows (although they may still be regulated). The Renminbi is now completely current-account convertible but is only partially capital-account convertible.

Introduction

- Capital-account convertibility is a pre-requisite for a market-determined exchange rate for the Renminbi. If capital flows are restricted, the demand and supply for Renminbi for capital account purposes will not be fully reflected in the foreign exchange market and the Renminbi exchange rate determined in such a market will therefore not represent the true equilibrium Renminbi exchange rate.

The Costs and Benefits of Short-Term Capital Flows

- Economic theory tells us that free international trade flows are beneficial to trading partner countries. Long-term capital flows in the form of direct investment or long-term portfolio investment are also known to benefit both the investor and the investee countries. However, there is no theory to support the hypothesis that short-term capital flows are beneficial to either the economy of origin or the economy of destination.
- International trade flows are relatively stable. Foreign direct investment flows, both inbound and outbound, are basically long-term in nature and hence also relatively stable on the whole. The same is true of long-term portfolio investment flows.

The Costs and Benefits of Short-Term Capital Flows

- However, short-term cross-currency international capital flows are susceptible to abrupt changes in magnitude and direction (e.g., hot money) that can greatly de-stabilise the financial markets of a country, including its foreign exchange market, credit market and capital market, impacting the real economy negatively.
- But the most compelling argument against such short-term cross-currency international capital flows is that, with the exception of short-term trade-related financing, they are not socially productive.

The Costs and Benefits of Short-Term Capital Flows

- Short-term cross-currency capital inflows cannot be usefully deployed in the destination country. When they are used to finance long-term investments in the destination country, they invariably lead to trouble because of the maturity mismatch, and further exacerbated by the currency mismatch. The 1997-1998 East Asian currency crisis is basically the outcome of massive maturity and currency mis-match in the loans taken out by enterprises in the East Asian economies.
- Moreover, as short-term capital flows in and out of the destination country, they cause the exchange rate and/or the interest rate of the destination country to become excessively volatile, inhibiting not only the flows of its international trade and long-term investment but also the development of the domestic real economy.
- Thus, it is desirable to be able to differentiate between long-term capital flows, which should be welcomed and encouraged, and short-term capital flows, which should be discouraged.

Regulation of Short-Term Capital Flows with a Tobin Tax

- A Tobin Tax, originally proposed by the late Prof. James Tobin, Nobel Laureate in Economic Sciences, can be an effective means of differentiating between short-term, mostly speculative, capital flows and long-term capital flows such as direct investment and long-term portfolio investment and their repatriation.
- Moreover, a Tobin Tax can actually make possible simultaneously the “Impossible Trinity”.

Regulation of Short-Term Capital Flows with a Tobin Tax

- For the sake of the present argument, a Tobin tax may be taken as as a tax of say 1% on all spot conversions of a foreign currency into Renminbi or vice versa that are not related to underlying current-account transactions.
- Thus, foreign currency transactions related to the exports or imports of goods and services will be completely exempted from such a tax. In practice, even capital account transactions below a certain threshold level, say 0.5 million Yuan (approximately US$83,500 at the current exchange rate), should probably also be exempted in order to simplify and facilitate effective enforcement without imposing undue burdens on relatively small capital account transactions.

Regulation of Short-Term Capital Flows with a Tobin Tax

- Such a Tobin Tax is intended to impose a penalty on short-term purely financial round-trip excursions from a foreign currency into the Renminbi or vice versa, and thereby discourage short-term cross-currency capital flows.
- If every time a foreign currency is converted into Renminbi or vice versa, a tax of say 1% is levied, then a round-trip within a month would amount to an effective cost of more than 24% per annum, whereas for a direct investment with a long time horizon of say 5 years, the tax will amount to only 0.4% per annum, virtually nothing.
- Thus, a Tobin Tax on capital flows will help to differentiate between short-term and long-term capital flows.

Enabling the “Impossible Trinity”

- The “Impossible trinity” (sometimes also referred to as the Trilemma) is a theorem in international economics which states that it is impossible to have simultaneously all three of the following supposedly desirable outcomes:
- A stable exchange rate;
- Free capital flows; and
- An autonomous interest rate policy.
- However, as mentioned above, the imposition of a Tobin Tax on capital flows in both directions can make all three seemingly simultaneously impossible outcomes simultaneously possible.

Enabling the "Impossible Trinity"

- Suppose that the one-month Renminbi rate of interest is 3% per annum and the one-month U.S.$ rate of interest is 0.5% per annum.
- There is then in principle a risk-free return of 2.5% to reward capital inflows from the U.S. into China given a fixed exchange rate and free capital flows until there is so much liquidity in China that the Renminbi interest rate falls and so little liquidity in the U.S. that the U.S. interest rate rises. The capital flows will stop when the Chinese and the U.S. interest rates are equalized at somewhere between their initial rates of interest.
- In the case of a small economy, the rate of interest of the small economy will fall or rise to the U.S. interest rate. It is in this sense that an autonomous interest rate policy is not possible for a small open economy.

Enabling the "Impossible Trinity"

- Now, suppose a 1% Tobin Tax is levied on all capital inflows and outflows. With such a tax, a round-trip capital flow into China within one month will incur a cost of 24% per annum, which is much higher than the 2.5% per annum interest rate differential. Even a round-trip capital flow into China of one-year duration will only earn an additional return of 0.5% (2.5% - 2%) per annum. (Of course the one-year interest rate differential may be different from the one-month interest rate differential.) However, it is clear that interest rate arbitrage is unlikely to be very profitable, even with the use of leverage.
- Thus, it is possible to have simultaneously a fixed exchange rate, free capital flows (subject to a 1% Tobin tax on both inflows and outflows), and a interest rate differential with the rest of the World.

Towards Capital Account Convertibility (and a Market-Determined Exchange Rate)

- By discouraging short-term capital inflows and outflows, China can avoid having the Renminbi exchange rate become an object of gambling and speculation by the hedge funds of the World, which is not the interests of China.
- The average daily volume of foreign exchange transactions worldwide in 2013 was approximiately US$5.3 trillion. This is equivalent to approximately US$1.325 quadrillion per year, on the basis of 250 working days per year. The total annual volume of international trade, including trade among countries and regions that do not require currency conversions such as within the Euro Zone, is approximately US$45 trillion in 2013, which is only 3.4% of the total volume of foreign exchange transactions.

Towards Capital Account Convertibility (and a Market-Determined Exchange Rate)

- Since both exports and imports are included in total world trade, they require at most one currency conversion, e.g., a Chinese importer will need to convert from Renminbi to U.S.$ to pay the Indonesian exporter and the Indonesian exporter will need to convert from U.S.$ to Indonesian Rupiah. It is possible that some exporters or importers may require some currency hedging, but altogether they cannot amount to more than twice the underlying trade transactions, and therefore cannot account for more than 6.8% of the foreign exchange transactions worldwide.
- There are also cross-currency direct investment and portfolio investments that require foreign exchange transactions, but they cannot amount to that much. Average annual international direct investment flow is probably no more than US$2 trillion.

Towards Capital Account Convertibility (and a Market-Determined Exchange Rate)

- The bulk of foreign exchange transactions consists of short-term gambling and speculation, causing unnecessary fluctuations in the currency exchange rates, which generate no benefits to real economies but create large profits for banks handling these transactions. These banks are in effect operating "legal casinos", so to speak (and there have been allegations of price-fixing in foreign exchange markets by the major multinational banks). Moreover, the volatility of the exchange rates caused by such speculation further increases the demand for foreign exchange hedging and hence foreign exchange transactions.
- The volatility of the exchange rates also discourages international trade flows in goods and services and long-term direct and portfolio investment flows.
- Finally, this volatility also benefits the U.S. Dollar as the dominant and only safe haven currency.

Towards Capital Account Convertibility (and a Market-Determined Exchange Rate)

- The imposition of a Tobin Tax can greatly reduce short-term capital inflows and outflows and hence the volatility of the Renminbi exchange rate, which is beneficial to international trade and cross-border direct and long-term portfolio investment.
- Freed of short-term speculative capital flows, the foreign exchange market can be allowed to play a more decisive role in the determination of the Renminbi exchange rate.
- Moreover, by increasing the cost of capital inflows from other countries, the imposition of a Tobin Tax by China also helps to retain the liquidity in the monetarily easing countries where it is supposedly intended and needed.

Concluding Remarks

- Capital account convertibility of the Renminbi, in the sense that both inbound and outbound capital controls will be effectively lifted, is expected to be achieved by 2020.
- It can occur sooner if short-term speculative capital flows (hot money), both inbound and outbound, which do not benefit the real economy of any country, can be appropriately regulated through the imposition of a Tobin Tax.
- With short-term speculative capital flows successfully discouraged under such regulation, the market can be allowed to play a much more decisive role in the determination of the Renminbi exchange rate.